

## FORMAL ISSUE PAPER

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

Issue Paper Number 99-013

4/20/99 ☐ Board Meeting  
☒ Business Taxes Committee  
☐ Customer Services Committee  
☐ Legislative Committee  
☐ Property Tax Committee  
☐ Technology & Administration Committee  
☐ Other



BOARD OF EQUALIZATION  
**KEY AGENCY ISSUE**

# REGULATION 1587 - ANIMAL LIFE, FEED, DRUGS AND MEDICINES APPLICATION OF TAX TO CELLULOSE CASINGS

## I. Issue

Should Regulation 1587, Animal Life, Feed, Drugs and Medicines be amended to allow a tax exemption for the sale of cellulose casings used in the manufacture and production of meat products and ultimately incorporated into or resold as feed for food animals or non-food animals which are to be sold in the regular course of business.

## II. Staff Recommendation

It is the staff's recommendation that no changes be made to the current interpretation of Regulation 1587 as it applies to the application of tax to cellulose casings, due to lack of statutory authority. The current Sales and Use Tax Law does not support exempting from tax the sale and use of cellulose casings purchased and functionally used in manufacturing processed meat for human consumption, even though the casings are ultimately resold or may be incorporated into exempt animal feed.

## III. Other Alternative(s) Considered

- (1) Amend Sales and Use Tax Regulation 1587, Animal Life, Feed, Drugs, and Medicines, as recommended by industry to reflect a tax exemption for the sale or use of cellulose casings used in manufacturing meat products and, thereafter, resold as or incorporated into exempt animal feed.
- (2) Pursue legislation to provide an exemption from the tax for cellulose casings purchased for use in manufacturing meat products and, thereafter, resold as or incorporated into exempt animal feed.

## IV. Background

The California Poultry Industry Federation has proposed an amendment to Regulation 1587, Animal Feed, Life, Drugs and Medicines to provide an exemption from the tax for the original sale or purchase of cellulose casings that are used in processing meat products for human consumption provided the casings are eventually incorporated into exempt animal feed.

Cellulose casings are sold by two or three large out-of-state suppliers to manufacturers of skinless sausages for human consumption. The casings are purchased in rolls of plastic-looking tubes made of cellulose material that is not fit for human consumption. The casings are stuffed with meat and cooked or smoked to form sausages. During this process, the cellulose casings absorb flavors, protein and fat from the processed meat as a result of the cooking or smoking process. After the meat is cooked or smoked and prior to the sale of the sausages, the casings are removed. In the past, casings were discarded after their use in meat processing.

Changes in technology have allowed producers of meat products such as sausages to recycle cellulose casings after they are separated from the sausages. The casings are cut into a uniform size and shape, and sold or used for mixing with feed for poultry and cattle. The casings mixed with the feed provide poultry and cattle a source of fiber and flavor, in addition to protein and fat absorbed during the cooking or smoking process. According to the poultry industry, the primary purpose in mixing the chopped casings with feed is for the nutritional benefit.

Sales of cellulose casings to meat processing manufacturers are currently considered taxable as consumable supplies used in manufacturing meat products for human consumption, regardless of the ultimate use of the casings.

Under existing statute, section 6358 provides an exemption from the sales and use tax for feed for any form of animal life of a kind the products of which ordinarily constitute food for human consumption, or are to be sold in the regular course of business. Regulation 1587, Animal Life, Feed, Drugs and Medicines, that interprets this section does not provide an exemption for the sale or use of cellulose casings purchased for use in manufacturing and resold as, or incorporated into, ingredients mixed with exempt animal feed. Industry is seeking amendments to this regulation to recognize that cellulose casings which are sold as or incorporated into animal feed are exempt under section 6358, just as other animal feed.

Regulation 1525, Property Used in Manufacturing, subdivision (a) provides in part that tax applies to the sale of tangible personal property to persons who purchase it for the purpose of use in manufacturing, producing or processing tangible personal property and not for the purpose of physically incorporating it into the manufactured article to be sold. Regulation 1525(b) provides that tax does not apply to sales of tangible personal property to persons who purchase it for the purpose of incorporating it into the manufactured article to be sold, as, for example, any raw material becoming an ingredient or component part of the manufactured article.

Where there are multiple uses but one primary purpose for the purchase of tangible personal property, the entire unit of material is taxed or not taxed, depending on that purpose. In determining whether the sale of a property is taxable or exempt, the Board and the courts have consistently looked to the primary intent of the purchaser or primary purpose of the purchase. *Kaiser Steel Corporation v. State Board of Equalization* (1979) 24 Cal.3d 188, in summary held, if the property is purchased as an aid in the manufacturing process, it is taxable despite the fact that some portion remains in the finished product or that an incidental waste or by-product results. Conversely, if the property is purchased for incorporation as a component of a finished product, it is not taxable even though the property may be used as an aid while it is being incorporated or attached in the manufacturing process.

Further, tangible personal property is regarded as having been purchased for the purpose of use in manufacturing tangible personal property and not for the purpose of being physically incorporated into the manufactured article to be sold, if the property is first utilized as an aid in the manufacturing process prior to its being incorporated into the end product. Independent intervening use of the purchased property as a manufacturing aid prior to its resale is subject to tax, even if the property was purchased for the purpose of incorporation into an end product.

Although not in the context of exempt animal feed, the California Court of Appeal held that cellulose sausage casings used in the manufacture of skinless wieners but removed and destroyed prior to sale were neither exempt food products nor exempt containers. As tangible personal property, their sale was subject to the Sales and Use Tax. *Luer Packing Co. v. State Board of Equalization* (1950) 101 Cal.App.2d99.

As an additional note, Assembly Bill 803 was introduced by Assembly Member Mike Machado in February 1997 to exempt from Sales and Use Tax cellulose casings, used in the manufacture and production of processed meat products, which are incorporated into exempt animal feed. The bill advanced as far as the Senate Appropriations Committee where it was

eventually held without recommendation. The California Poultry Industry Federation believes the Board staff misinformed both the Legislature and the Poultry Industry by stating that legislation was required because “under current law cellulose casings used and discarded are subject to tax,” without discussing the application of tax to the facts for which the exemption was sought.

**Discussion of Issue:**

The California Poultry Industry Federation believes that Sales and Use Tax Law section 6358 provides the Board with the authority to amend Regulation 1587 without additional changes to the statutes, based on the following fact pattern:

“Current technology allows for the simultaneous manufacturing of two desired end products, the sausages and the cellulose casings infused with nutrients. Placing the sausage meat into the casing and smoking both is an essential first step in converting the casing into feed for food animal. Without that first step, or a similar step, the casings could not be used as feed for food animals. There is no “first use” that is inconsistent with converting the casings into feed for food animals. The smoking process alters both the casing and the sausage and makes both desirable end products with separate and distinct markets. The fact that the cellulose casings are also a desired end product is demonstrated by industry’s willingness to purchase additional equipment to further process the casings. While cellulose casings may not be currently as valuable as the sausage, that is not a basis for imposing a tax on the casing.”

“Both the casing and the sausage are “used” in the cooking process to produce two separate end products. However, it is not the type of use that subjects either item to the use tax. In order to sustain the use tax on either the casing or the sausage, the proper test is whether the casing performed, during the cooking process, some separate and distinct function that provided benefit only to the sausage and provided no benefit to the casing. There is no such separate and distinct use here. A manufacturer can simultaneously produce two end products, one of low value and one of a higher value without incurring a use tax on either, unless the above test is met. There is no separate and distinct use here. The cooking process is necessary to manufacture both sausage and casings, which will become an animal feed ingredient.”

“The “principal purpose test” that staff applies, at times, generally to the manufacture of non-food or feed items, is not applicable to the proposed amendments. The “principal purpose test” addresses manufacturing aids which are placed into the manufacturing process for some type of “first use,” and may then incidentally remain with the end product, but have no value in the end product. The proposed amendments only provide an exemption where the casings have value as an end product. There is no “first use” on the casings.”

To determine whether the original sale of the cellulose casings to a sausage manufacturer is an exempt or taxable transaction, staff believes the “primary purpose” test is applicable. The analysis remains the same whether the uses are successive or simultaneous. Where there are simultaneous uses but only one primary purpose for the purchase, the entire unit of material is taxed or not taxed, depending on that purpose. The original purchase of cellulose casings would be taxable if the casings are purchased primarily to form skinless sausages for human consumption, lacking statutory authority to exempt the original purchase when the processed casings are ultimately used or resold as exempt animal feed. The purchase would be exempt if the casings are primarily purchased for processing into animal feed by infusing fats and proteins into them and mixing or reselling them for animal feed. Staff believes the cellulose casings continue to be purchased primarily for use as manufacturing aids to form skinless sausages. Further, assuming the original purchase of the casings was primarily for processing the casings into animal feed, the use of the casings as aids in manufacturing sausages for human consumption would be considered a substantial intervening use of the casings in a nonexempt manner.

Staff believes an analogous situation exists with the chicken litter exemption provided in Sales and Use Tax Law section 6358.2, operative January 1, 1994, in that the end use of the property dictates whether the original sale or purchase is exempt from the sales and use tax. That section was added to exempt from taxes the sale or use of wood shavings, sawdust, rice hulls, or other products that are used as litter in poultry and egg production and that are ultimately resold as, or incorporated into fertilizer products, even though an exemption for fertilizer applied to land to grow food for human consumption or sold in the regular course of business has been part of the Sales and Use Tax Law section 6358 since 1943. Prior to section 6358.2, the intervening use of the chicken litter was considered taxable regardless of the fact the ultimate use of the product was used to produce food for human consumption.

Comparison Table provides a summary of the proposed regulation revision and recommended action.

## **V. Staff Recommendation**

### **A. Description of the Staff Recommendation**

It is the staff's recommendation that no changes be made to the current interpretation of Regulation 1587 as it applies to the application of tax to cellulose casings, due to lack of statutory authority. The present Sales and Use Tax Law does not support exempting from tax the sale and use of cellulose casings purchased and functionally used in manufacturing processed meat for human consumption, even though the casings are ultimately resold or may become exempt animal feed.

### **B. Pros of the Staff Recommendation**

- Does not require legislative action or revision to existing regulations.
- Maintains consistency with the application of tax to personal property used in the manufacturing of end products.
- Does not require any change in reporting method for taxpayers.

### **C. Cons of the Staff Recommendation**

- According to industry, California is the only remaining state that imposes a tax on cellulose casings used in meat processing and subsequently used in animal feed. Industry feels California meat processors are at a competitive disadvantage over out-of-state processors, especially for export.

### **D. Statutory or Regulatory Change**

- None. The staff recommendation is the current method of reporting.

### **E. Administrative Impact**

- There is no administrative impact.

### **F. Fiscal Impact**

- There is no anticipated cost or revenue impact.

**G. Taxpayer/Customer Impact**

- There is no anticipated taxpayer/customer impact.

**H. Critical Time Frames**

- There are no critical time frames.

**VI. Alternative 1****A. Description**

Amend Sales and Use Tax Regulation 1587, Animal Life, Feed, Drugs, and Medicines, to reflect a tax exemption for the sale or use of cellulose casings used in manufacturing meat products and thereafter resold as or incorporated into exempt animal feed. See Comparison Table for industry proposed change to Regulation 1587, subdivision (b).

**B. Pros of Alternative 1**

- Does not require legislative action.
- Will create parity with out-of-state meat processors, especially for export.

**C. Cons of Alternative 1**

- Such an exemption is contrary to existing statutory law.
- Granting an exemption for the purchase of cellulose casings and the resulting claims for refund may have a budgetary impact on some local jurisdictions.

**D. Statutory or Regulatory Change**

- If the Board adopts the proposed exemption for cellulose casings, Regulation 1587 would have to be amended.
- The issue of providing the exemption on a prospective or retroactive basis would need to be addressed. Unless the Board provides an effective date for the amendment, the exemption would have a retroactive effect.

- Should the amendment be adopted, the following underlined revisions to industry's proposal are suggested to clarify that the exemption would apply to the original sale or use of cellulose casings in this state:

“(B) Cellulose Casings. Tax does not apply to the sale or use of cellulose casings which are used in the manufacture and production of processed meat products and which are thereafter ultimately resold as, or incorporated into, feed for food animals or non-food animals which are to be sold in the regular course of business.”

**E. Administrative Impact**

- The cost to notify taxpayers would be absorbable.

**F. Fiscal Impact**

- Cost impact - Considered to be absorbable.
- Revenue impact - Estimated at \$824,000 per year. If the change is considered declaratory of existing statutes, potential refunds for three years for a total of \$2.5 million could result. See Revenue Estimate for details.

**G. Taxpayer/Customer Impact**

- Taxpayers would be allowed to file claims for refund for taxes paid on purchases of cellulose casings, subject to the statute of limitation.
- Meat processors that cannot document the resale of processed casings or the mixing with exempt animal feed would not be eligible for a refund.

**H. Critical Time Frames**

- There are no critical time frames.



## **VII. Alternative 2**

### **A. Description**

Pursue legislation to provide an exemption from the tax for cellulose casings purchased for use in manufacturing meat products and, thereafter, resold as, or incorporated into exempt animal feed.

### **B. Pros of Alternative 2**

- The exemption would be supported by statute.
- Will create parity with out-of-state meat processors, especially for export.

### **C. Cons of Alternative 2**

- Requires legislative action.
- Granting an exemption for the purchase of cellulose may have a budgetary impact on some local jurisdictions.

### **D. Statutory or Regulatory Change**

- A legislative bill would have to be introduced or an existing bill modified to provide statutory exemption.

### **E. Administrative Impact**

- The cost to notify taxpayers would be absorbable.

### **F. Fiscal Impact**

- Cost Impact - Considered to be absorbable.
- Revenue impact - Estimated at \$824,000 per year. See Revenue Estimate for details.

### **G. Taxpayer/Customer Impact**

- Meat processors that cannot document the resale of processed casings or the mixing with exempt animal feed would not be eligible for a refund.

### **H. Critical Time Frames**

- The legislative recess for 1999 begins on September 10 and the legislature reconvenes on January 3, 2000.

BOARD OF EQUALIZATION  
**REVENUE ESTIMATE**

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**REGULATION 1587 – ANIMAL LIFE, FEED, DRUGS AND MEDICINES**  
**APPLICATION OF TAX TO CELLULOSE CASINGS**  
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**Alternative Proposals**

The alternative proposals would exempt from the sales and use tax cellulose casings purchased for use in manufacturing meat products and, thereafter, resold as or incorporated into exempt animal feed.

**Background, Methodology, and Assumptions**

The sausage industry uses a variety of casings – some natural and some synthetic. Natural casings remain on the sausages when the sausages are sold to consumers and, therefore, are exempt as food for human consumption. Synthetic casings are non-edible and are removed from the sausages (and either discarded or put to another use) before the sausages are sold to consumers. Those casings are subject to tax currently. Cellulose casings, which are synthetic, represent one of the highest volume casings used in the United States.

The 1992 Census of Manufactures, Industry Series - Meat Products (the most recent issue), published by the U. S. Department of Commerce, reports a value of shipments for California producers of sausage and similar products of \$353.6 million. Total U. S. production was shown as \$5,745.7 million. California production was 6.15 percent of the total U. S. production.

The same report showed that the delivered cost of synthetic sausage casings amounted to \$169.6 million in the United States for producers of sausages and other prepared meats. Assuming that California represents 6.15 percent of that amount yields an estimated \$10.4 million in purchases of sausage casings by California producers. Industry representatives have indicated that most used cellulose casings are incorporated into animal feed, thereby causing their sale to the sausage producer to be exempt under the alternative proposals.

## Revenue Summary

The alternative proposals would have an annual revenue effect of reducing sales and use tax revenues at an average sales tax rate of 7.92 percent as follows:

	<u>Revenue Effect</u>
State reduction (5%)	\$ 520,000
Local reduction (2.25%)	234,000
Special district reduction (.67%)	<u>70,000</u>
Total	824,000

If the exemption of casings were to take the form of an amended regulation, potential refunds for 3 years for a total of \$2.5 million could result.

## Preparation

This revenue estimate was prepared by Jeff Reynolds, Statistics Section, Agency Planning and Research Division. It was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division. For additional information, please contact Mr. Reynolds at (916) 445-0840.

Current as of March 22, 1999

**Regulation 1587, Animal Life, Feed, Drugs and Medicines - Application of Tax to Cellulose Casings**  
*Comparison of Current Regulation with Industry Proposal As of April 2, 1999*

<b>Current Version of Regulation 1587, Subdivision (b)</b>	<b>Proposed Revisions to Regulation and Comments made by Industry</b>	<b>Staff Recommendation</b>
<p>(b)FEED.</p> <p>(1) DEFINITION. The term “feed” as used herein includes cod-liver oil, salt, bone meal, calcium carbonate, double purpose limestone granulars and oyster shells, but does not include sand, charcoal, granite grit, sulphur and medicines. It also includes any item which is purchased for use as an ingredient of a product which would constitute a feed were the product itself sold.</p> <p>(2) APPLICATION OF TAX.</p> <p>(A) In General. Tax does not apply to sales of feed for food animals or for any non-food animals which are to be sold in the regular course of business.</p>	<p>No change to subdivision (a)</p> <p>(b)FEED.</p> <p>(1) DEFINITION. The term “feed” as used herein includes cod-liver oil, salt, bone meal, calcium carbonate, double purpose limestone granulars and oyster shells, but does not include sand, charcoal, granite grit, sulphur and medicines. It also includes any item which is purchased for use as an ingredient of a product which would constitute a feed were the product itself sold.</p> <p>(2) APPLICATION OF TAX.</p> <p>(A) In General. Tax does not apply to sales of feed for food animals or for any non-food animals which are to be sold in the regular course of business.</p> <p><u>(B) Cellulose Casings. Tax does not apply to cellulose casings used in the manufacture and production of processed meat products which are ultimately resold as, or incorporated into, feed for food animals or non-food animals which are to be sold in the regular course of business.</u></p>	<p>No change to current subdivisions (b)(2)(B) and (C). The use of the cellulose casings in processing meat product for human consumption is the primary purpose for the purchase of the casings and constitutes substantial intervening use in forming and cooking sausages.</p>

**Regulation 1587, Animal Life, Feed, Drugs and Medicines - Application of Tax to Cellulose Casings**  
*Comparison of Current Regulation with Industry Proposal As of April 2, 1999*

<b>Current Version of Regulation 1587, Subdivision (b)</b>	<b>Proposed Revisions to Regulation and Comments made by Industry</b>	<b>Staff Recommendation</b>
<p>(B) Medicated Feed. Tax does not apply to the sale of medicated feed, the primary purpose of which is prevention and control of disease of food animals or of non-food animals which are to be sold in the regular course of business. Tax also does not apply to sales of the particular ingredients purchased from different sellers by a purchaser who mixes them for feeding to such animal life, in such proportions that the product is an exempt medicated feed rather than a drug.</p>	<p>(BC) Medicated Feed. Tax does not apply to the sale of medicated feed, the primary purpose of which is prevention and control of disease of food animals or of non-food animals which are to be sold in the regular course of business. Tax also does not apply to sales of the particular ingredients purchased from different sellers by a purchaser who mixes them for feeding to such animal life, in such proportions that the product is an exempt medicated feed rather than a drug.</p> <p>No changes to subdivisions (c) and (d).</p>	<p>Although staff recommends no changes be made to the regulation, should the Board adopt the amendments, the following alternative language to industry's proposal is suggested:</p> <p>(B) Cellulose Casings. Tax does not apply to <u>the sale or use of</u> cellulose casings <u>which are</u> used in the manufacture and production of processed meat products <u>and</u> which are <u>thereafter</u> ultimately resold as, or incorporated into, feed for food animals or non-food animals which are to be sold in the regular course of business.</p> <p>If this is adopted, current subdivision (b)(2)(B) would become (b)(2)(C).</p>